# Legal Sector Benchmarking

## Annual Report

February 2021

ArmstrongWatson®
Accountants, Business & Financial Advisers
A track record of providing solutions to the legal profession
www.armstrongwatson.co.uk/legalsector

Working with
The Law Society

## Contents



## Commentary

We have prepared this report using information from the law firms we advise. We supply a bespoke individual report to all of our legal sector clients as part of our standard added value service when discussing their annual accounts. Those individual discussions allow us to take more of a strategic stance with our legal clients.

We act for over 100 law firms throughout the UK each year. This document is the annual report summarising the results of those individual practices. The results cover firms of all sizes, throughout the UK. Where possible the results have been analysed by practice size. The practice size has been determined in terms of the number of full equity partners within firms, excluding fixed share equity partners and salaried partners. Although we have classified firms with 1-7 full equity partners, as being small and those with 8+ full equity partners as large, in reality, law firms with 8+ full equity partners are very much at the larger end of the legal market given the demographics of the sector.

The report is our analysis and comparison of the years ending in 2019 and 2020. There is no doubt that 2020 has been a strange and turbulent year for us all due to the impact of COVID-19. The latest news and advice relating to the legal sector and COVID-19 is included on our website at www.armstrongwatson.co.uk/services/covid-19-and-your-business/impact-covid-19-legal-sector.

In general, given that some of the results within our sample contain a substantial part of performance during the pandemic in 2020, the results are generally positive. The increased profitability has appeared to continue, although how much that is being masked by government support remains to be seen.

However, despite this increased profitability, cash still appears to be tight as lock up has slightly increased and drawings have fallen behind profits resulting in large increases in average partner capital accounts, which may cause succession problems in the future.

**The highlights from this 2019/20 report are as follows:-**

- The average fee income per equity partner was £798,000 which is 25% higher than in 2018/19.
- The average fee income per fee earner was £123,000 which is 7% higher than in 2018/19.
- The average net profit per equity partner was £159,000 which represents 5% of fee income. That has increased from £151,000 in 2018/19. Law firms with 8+ partners performed above this benchmark with average net profit per partner of £187,000. All of these profit statistics are the highest we've seen for a long time.
- Overheads have remained at a similar level to the previous year. We expect these to fall in 2020/21 and beyond, as the pandemic has seen firms reduce expenditure in office costs, printing, postage, travel and marketing in particular.
- On average there are 4.6 fee earners for every equity partner, an increase from 3.5 in 2018/19.
- Staff costs as a proportion of fee income have increased by 2.3% on the previous year to 41.9%.
- The number of staff per equity partner has increased from 6.2 people to 8.4 people.
- The number of support staff has remained broadly the same as the previous year.
- On average, equity partner charge out rates have increased by 11% across all law firms.
- Salaried partner, associate and assistant charge out rates have also increased by 34%, 14% and 25% respectively across all law firms. Trainee charge out rates have seen smaller inflationary increase of 13% on the previous year.
- The average time taken to bill work in progress has increased from 61 days to 67 days. The average time taken to collect debts has decreased from 59 days to 58 days.
- The average partner's capital account has increased by 61% from £170,000 to £273,000.

If you are interested in seeing how your firm compares with the benchmarks in this report or want to investigate variances with your own firm's performance then please contact me.

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Armstrong Watson LLP is a top 30 UK accountancy firm with 16 offices throughout Northern England and Southern and Central Scotland. Further information on our unique offering to law firms can be found at **www.armstrongwatson.co.uk/legalsector**

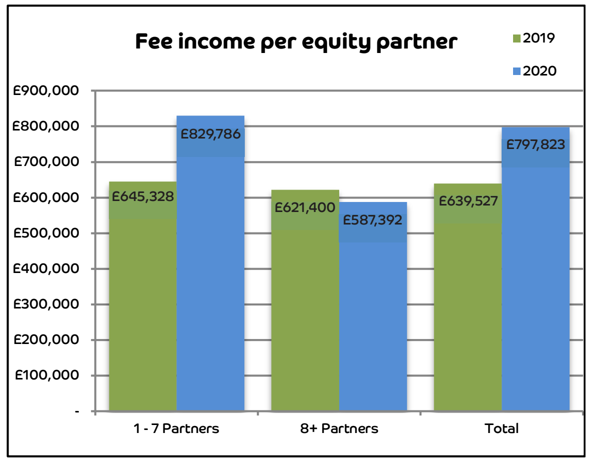
We have a team of 12 people that focus exclusively in acting for lawyers. That knowledge allows us to focus on improving the business of law rather than just the compliance requirements.

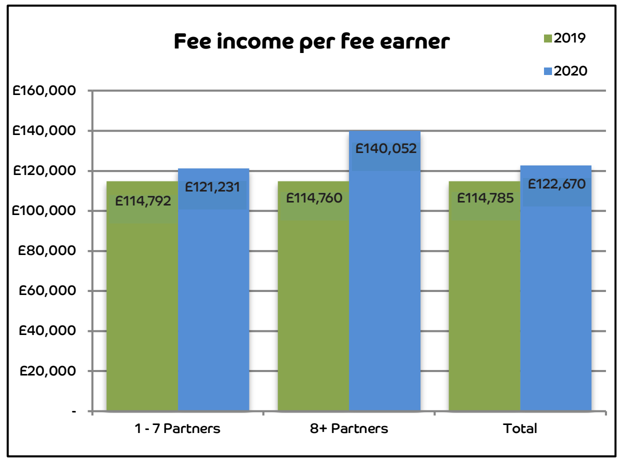
As you'd expect, we prepare your accounts, SRA Accounts Rules reports and tax returns in a knowledgeable and efficient manner, but we also help lawyers in a way that others don't through the provision of our bespoke added value services. Our focus has resulted in Armstrong Watson being the only accountancy practice that the Law Society has chosen to work with for the provision of accountancy services to law firms.

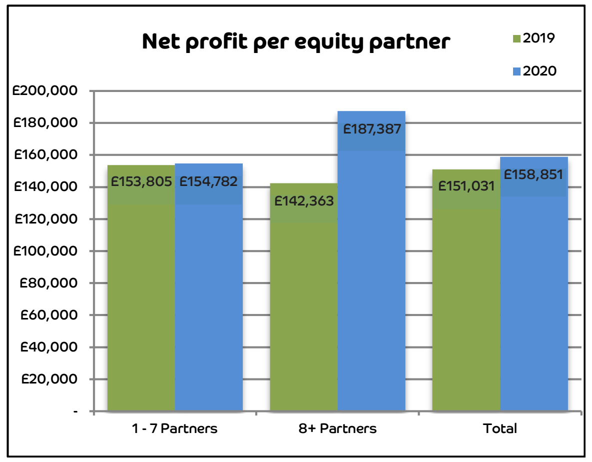
Our pro-activity stands us apart from other accountancy firms, generating our track record of providing solutions to law firms.

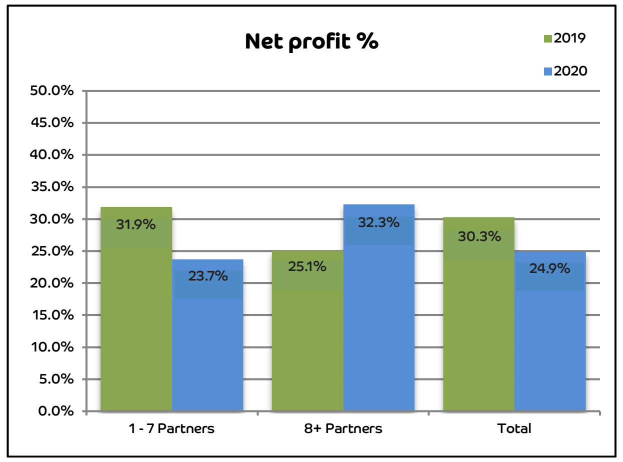


## Fee Income and Profits




When looking at the overall data for law firms, fee income per equity partner has increased by 25% from 2019 to 2020. The increase has been driven by law firms with 1-7 partners showing an increase of 29%, whereas in the law firms with a higher number of partners (8+) there has in fact been a decrease year on year of 5% as the total income of the firm is being shared across more equity partners.

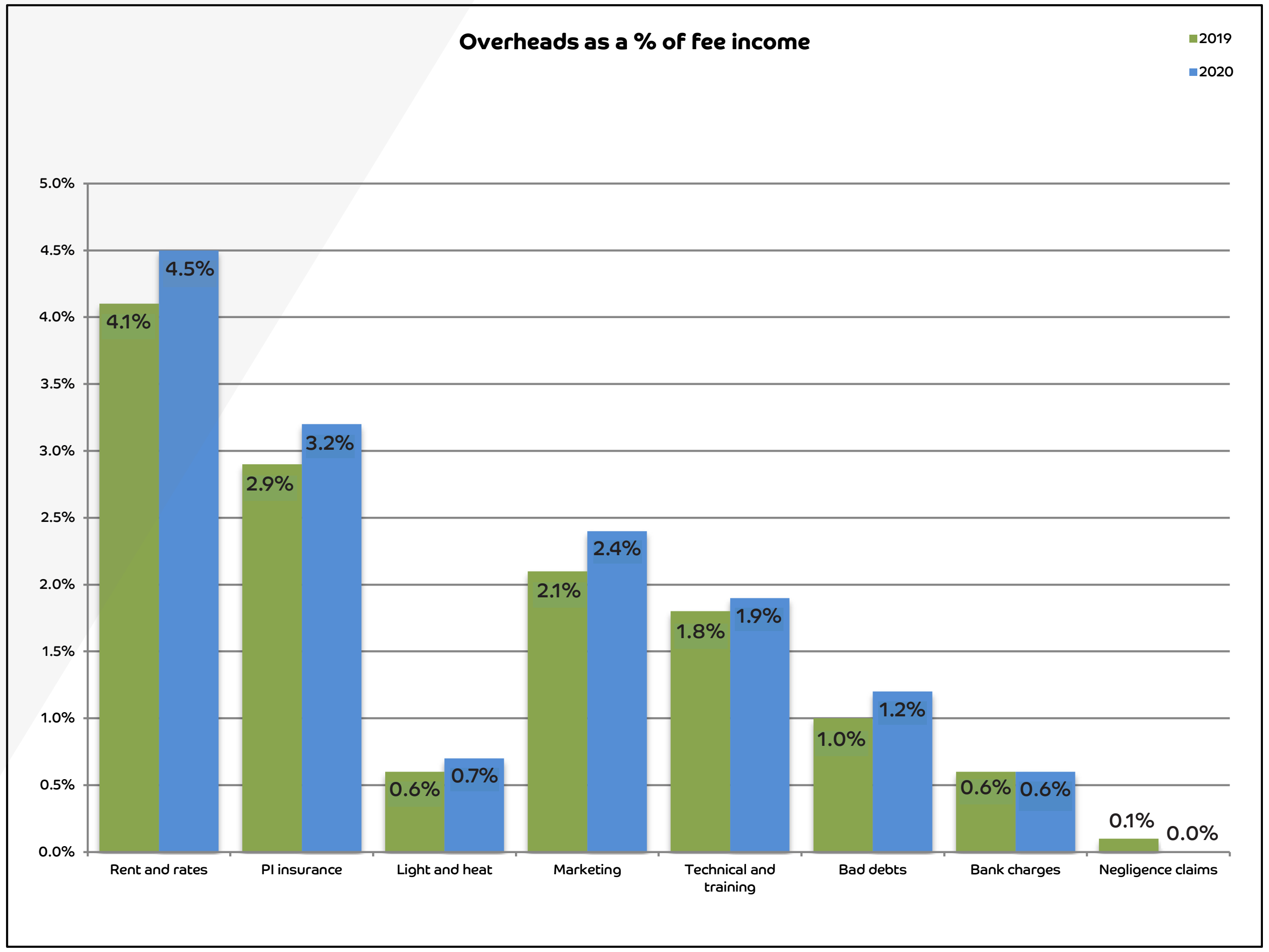
Despite that, for law firms with 8+ partners, fee income per fee earner has increased on the previous year. Developing fee earners and thereby growing this measure is how law firms improve (and sustain) their profitability and this can be seen in the net profit per equity partner and net profit % for 8+ partners which has also increased on the previous year. For firms with a lower number of partners, the fee income per fee earner has seen a much smaller increase and so follows that the increase in net profit per equity partner is also much smaller.

The net profit % (NP%) measure is one of the most important for law firms as it demonstrates whether the work that is being done by the firm is in fact profitable. When looking at all law firms, the NP% has fallen from 30.3% in 2019 to 24.9% in 2020. Looking at this by size of firm shows that in fact those firms with 8+ partners have increased their NP% from 25.1% to 32.3%, whereas those firms with fewer partners have driven the fall in NP%. One of the reasons for this may be that some of the very small firms within the data pool have taken on unprofitable work in a bid to drive their fee income up during the pandemic, and may also struggle to recover as well on their work due to their predominant client types. During the pandemic, we have also seen a trend towards more senior staff, and potentially equity partners, doing more of the fee earning work. In firms with a larger number of partners, it may be the case that some higher level employed staff have been furloughed, thereby saving costs, while the fee earning has been done by the partners themselves which has driven the increase in NP%.

A number of the 2020 year ends may well be March and April 2020, and so the full effect of the pandemic will not have been fully seen. For some of those firms, we have actually seen an increase in profitability, due to furlough support and reduced expenditure on offices, postage, printing, stationery, travel and marketing.

It will be interesting to see the impact on this measure next year and whether this trend continues.

# Overheads as a % of Fee Income




The above shows overheads as a percentage of fee income.
Controlling overheads is particularly important when there is potential future pressure on the levels of fee income as the ongoing pandemic continues to impact.

Rent and rates as a % of fee income have increased from 4.1% to 4.5%. When looking at the background data, it is clear that it is the smaller firms (by turnover) that have driven this; any rent increases have a proportionally larger impact on a smaller turnover base. It will interesting to see how this measure is impacted in the years following the pandemic and what decisions firms make regarding office space if there is a move towards increased home working. There will always be a requirement for some office space within legal practices, to allow supervision, collaboration and to embrace culture, but we would expect to see some impact on this measure in future years.

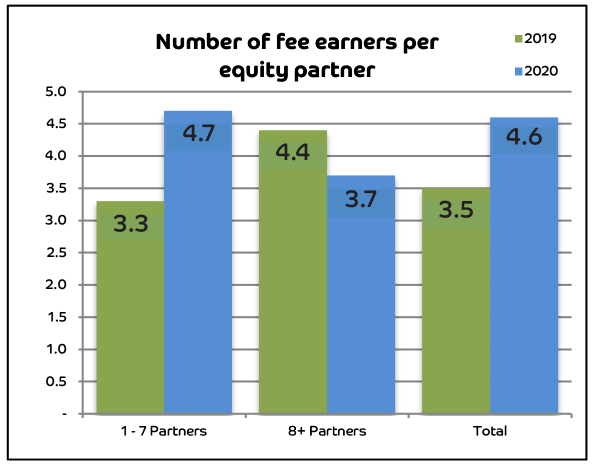
PI insurance has seen an increase year on year from 2.9% to 3.2%. This was expected given the hardening of the market where the number of insurers is decreasing and premiums are increasing. This measure is expected to only go in an upwards direction in the coming years, as most firms are reporting at least a 10% increase in their premiums during 2020.

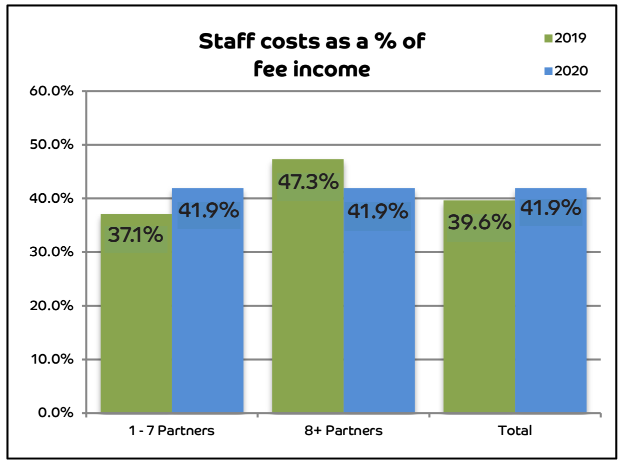
The other measure to note is marketing expenditure, which has continued to grow from 2019 to 2020. Again, it will be interesting to see what the impact on this measure is next year re: COVID-19, as there will have been very few costly face to face events during most of 2020, and going forward, firms will question ever more the return on investment in such events when they are able to be held again.

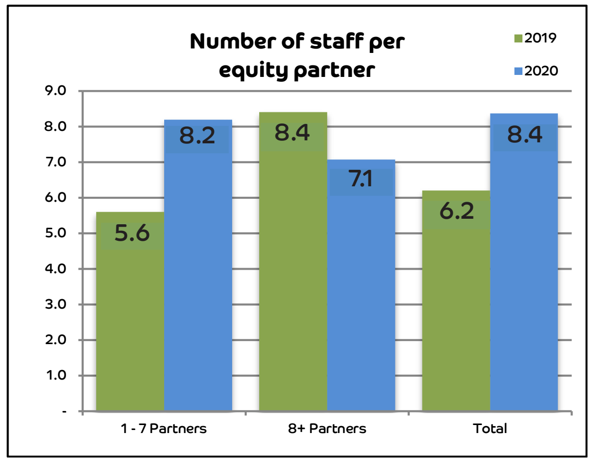
People costs are covered separately in the next section.

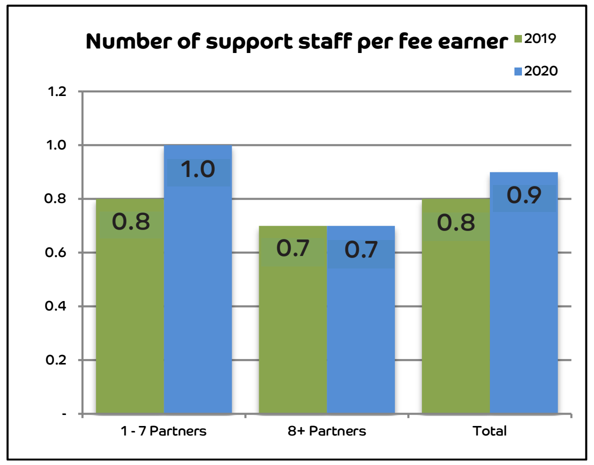


# People




On average there are 4.6 fee earners for every equity partner across all firm sizes. Firms with 8+ partners show a reduction in the ratio from 4.4 down to 3.7 fee earners for every equity partner. This reduction may be due to an increase in the number of firms with a strategic model whereby the work will be undertaken at a higher level rather than the equity partners winning the work and passing the work down, which could be linked with redundancy programmes that we have seen in some firms following furlough periods which may have demonstrated to some firms that they were previously over-staffed.

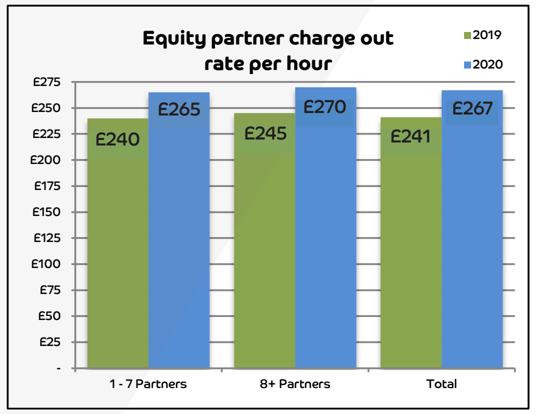
For law firms with 1-7 partners, this ratio has increased from 3.3 to 4.7 people, and as a measure this shows that firms with a smaller number of partners now have more fee earners per equity partner than those with more partners. Again turning to the background data, this demonstrates a changing legal sector market, whereby there are a number of our client firms falling into this smaller category as they have a limited number of true equity partners even though they are a larger firm in terms of fee income, with them having a higher number of fixed share or salaried partners, who would be classed as fee earners in the data above. In addition, in previous years we have seen partners exiting larger practices to start new, smaller, typically niche firms, and as they grow and take on more fee earners they don't necessarily add to the equity partner headcount - this has continued to increase the rate of change in this ratio for firms of this size.

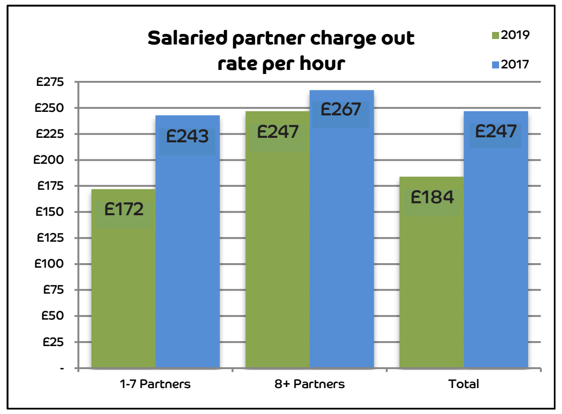
Staff costs as a percentage of fee income has increased from 39.6% to 41.9% across all firm sizes. Linked to the above for firms with 8+ partners, this ratio has reduced from 47.3% to 41.9% whereas for firms with a lower number of partners, this has increased from 37.1% to 41.9% which would include any fixed share or salaried partner costs and supports the changes in strategic thinking noted above.

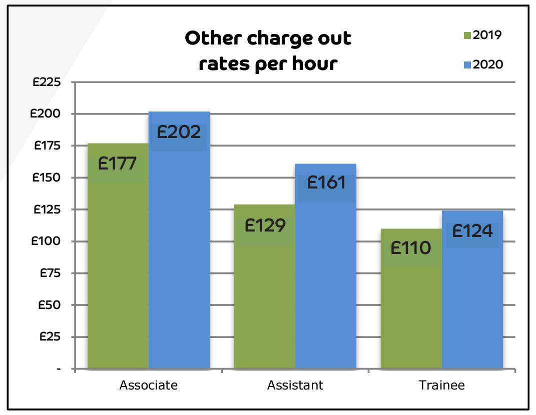
In total, the number of staff per equity partner has increased on average from 6.2 people to 8.4 people. Again these figures are higher for the smaller firms, which is reflected in the staff costs percentages. For firms with 8+ equity partners, this has fallen from 8.4 to 7.1.

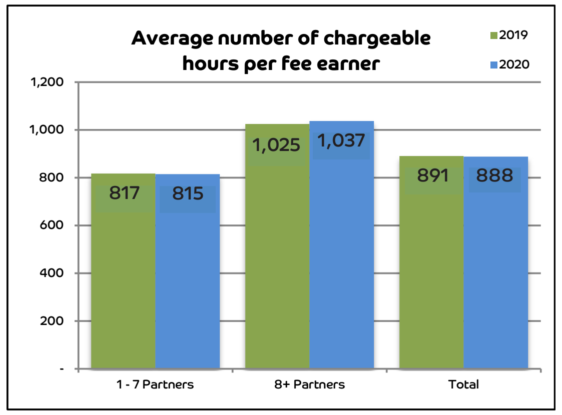
Following a period where the number of support staff per fee earner has remained broadly the same, firms with fewer partners have seen an increase since 2019. This may be driven by the smaller firms increasing their head count in ancillary areas such as IT as the importance of effective support in these areas was recognised. This measure may revert in future years following the pandemic as remote working forces fee earners to become more self sufficient which may reduce the numbers of traditional administration staff such as typists and secretaries,. Firms may also look to outsource certain specialist functions in future years, such as FDs, HR, IT and marketing, as these can often be sourced externally at a lower cost.

# Charge Out Rates




The equity partner charge out rates have increased for firms of all sizes by the same amount (10%) from 2019 to 2020.

Salaried partner charge out rates have increased by 41% in smaller firms to bring them to a similar level of the larger firms and suggests that they were under-valued in prior years, or that fewer experienced salaried/fixed share partners are becoming equity partners in law firms, but their seniority is being reflected in a similar charge out rate to full equity partners.

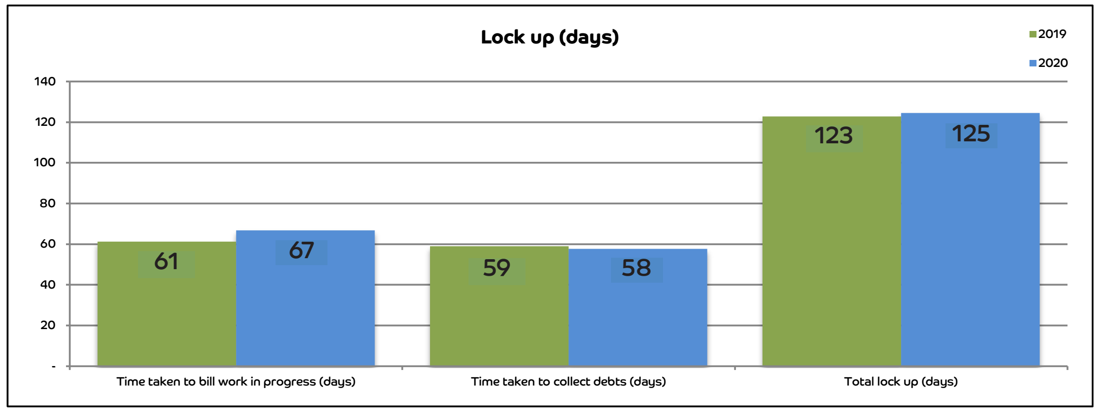
Associate, Assistant and Trainee charge out rates also show an increase across all firm sizes.

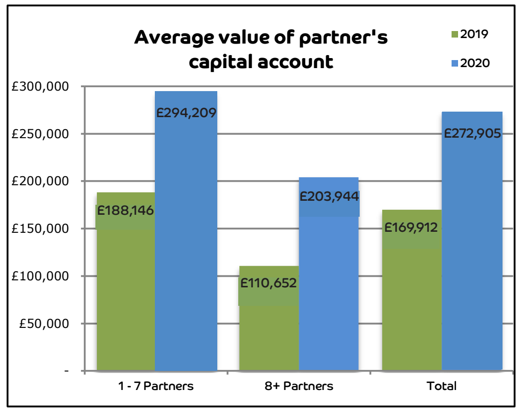
The average number of chargeable hours per fee earner on average has remained fairly stable. Firms with 8+ partners show a better performance than those firms with 1-7 partners. Given that the average level of fee income per fee earner has increased across all firm sizes, and there has been little movement in chargeable hours, it would appear that the increase in fee income per fee earner is being driven by the increase in charge out rates. As the increase in fee income per fee earner in firms with 8+ partners cannot be fully explained by the increase in charge out rates, it also suggests that as fee earners become busier, they act more efficiently, recovery rates increase and write offs decrease.

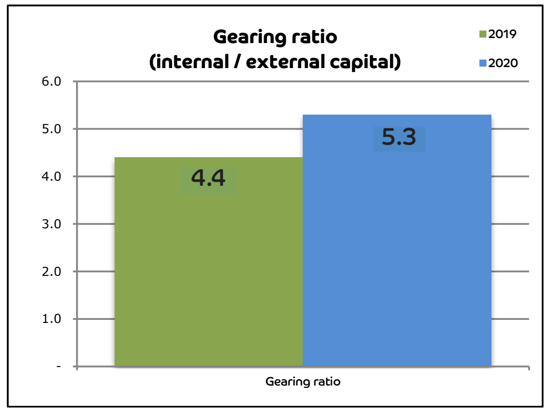
Under recording of time in some practices remains an issue, particularly in smaller firms.



# Working Capital




The average time taken to bill work in progress (WIP) has increased from 61 days to 67 days when compared with the previous year. This shows that law firms are raising fees slightly slower than previously. The ongoing pandemic is presenting challenges in this area as cases and work are taking longer to complete for a number of reasons (staff on furlough, child care responsibilities, slow response times from other sides etc). This will cause a resultant strain on their working capital requirements. It is important to review work in progress on a regular basis and invoice work as soon as it is possible to do so.

The number of days taken to collect debts has decreased slightly from 59 days to 58 days. This is pleasing as collecting debts from clients, certainly since the pandemic started, has presented difficulties as individuals and businesses look to stretch credit terms wherever possible. As with the WIP, it is vital to review debtors with the fee earners on a regular basis, particularly as the government support during the pandemic is withdrawn with there may be an increasing strain on the economy and finances generally.

The average value of an equity partner's capital account has increased by 61% from the previous year. This could be due to a number of factors; previous years of good profitability that has not necessarily been paid out due to lack of cash caused by lock-up levels, retention of reserves needed for working capital or refinancing of the practice, and nervousness (and restriction of drawings) due to COVID-19. Firms with a smaller number of partners have much larger capital accounts than those with 8+ partners. Again turning to the background data, this is due to a number of smaller boutique firms who are earning large profits with a small number of partners where profits are not being withdrawn to allow investment in the firm to facilitate growth. In addition, there are also a number of smaller firms (by number of partners) who are large in terms of turnover, therefore larger capital accounts are required to support the working capital of the firm.

Following on from the increase in capital accounts, the average gearing ratio has increased from 4.4 to 5.3 when compared with the previous year. This means that the amount the partners invest compared to the amount they borrow has increased. It should be noted that this ratio doesn't reflect "off balance sheet" finance, where partners have taken on personal debt to inject into the practice or as a part of a refinancing package.

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